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No. 87-1168

In the Supreme Court of the United States

OCTOBER TERM, 1987

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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In our petition, we explained that certiorari is appropriate here for the following reasons: (1) the decision below, which is incorrect (see Pet. 12-22), establishes a direct conflict with a line of previous court of appeals decisions, including *Shimberg* v. *United States,* 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979), on a recurring issue on which there are frequently large sums of money at stake (see Pet. 6-8, 14-16); (2) because the decision below is more advantageous to individual shareholders and the decision in *Shimberg* is more advantageous to corporate shareholders, the Internal Revenue Service (IRS) cannot avoid continued litigation on this issue by adopting either alternative (see Pet. 8-9); and (3) although this issue loses its significance to many individual shareholders in the absence of the rate differential between capital gain and ordinary income that was removed by the Tax Reform Act of 1986, the issue still has considerable administrative importance to the IRS because (a) it still will affect some individual shareholders, (b) it has lost

none of its significance to corporate shareholders, and (c) it may have collateral consequences on other important tax accounts such as basis and earnings and profits (see Pet. 9-11).Taken together, all of these factors will create substantial administrative problems for the IRS unless the conflict in the circuits is resolved.

Respondents do not seriously dispute the basic premises of our petition. While they note that there are "differences between the facts of this case and those of *Shimberg*" (Br. in Opp. 17 (footnote omitted)), they do not deny that the two decisions are in irreconcilable conflict. They acknowledge that the interests of corporate shareholders and individual shareholders are at odds on this issue and therefore that the IRS cannot satisfy both classes of taxpayers no matter what position it takes on the issue presented here. And they do not dispute that the elimination of the rate differential between capital gain and ordinary income does not affect the interests of corporate shareholders or of some individual shareholders who have capital losses on other transactions.[1] Respondents do contend, however, that for other reasons it is unnecessary for this Court to resolve the conflict in the circuits. This contention lacks merit.

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[1] Respondents do dispute (Br. in Opp. 18 n.23) our contention that the conflict in the circuits injects considerable uncertainty into the treatment of other important tax accounts, such as basis and earnings and profits. Respondents assert that it is clear that the courts should accept respondents' proffered hypothetical redemption scenario only for the limited purpose of justifying capital gain treatment, but then should ignore that scenario when determining the other tax consequences of the transaction that might work to respondents' disadvantage. This assertion is, at best, highly questionable. At a minimum, it is manifest that the terms of Section 356(a) do not, as respondents suggest, resolve the uncertainties of computing basis, gain, and earnings and profits, that are created by respondents' hypothetical redemption scenario.

1. Respondents suggest (Br. in Opp. 20-22) that the IRS should solve its administrative problems by embracing the decision below. To justify this recommendation that the IRS repudiate its longstanding position, respondents advance the unsupported assertions that *Shimberg* is "widely regarded as a 'sport' " (Br. in Opp. 6) and that "it is viewed by the tax bar generally as an aberrational decision" (*id.* at 20). Respondents' suggestion is wholly unsatisfactory.

First, far from being a "sport,"[2] *Shimberg* reflects the weight of authority on this issue. As we noted in our petition (at 14-16), a consistent line of court of appeals decisions dating back to 1934 has held that boot received in a reorganization on a pro rata basis by the shareholders of one of the corporations has the "effect of the distribution of a dividend" (I.R.C. § 356(a)(2)) and is to be taxed as such. It would be quite extraordinary for the IRS to react to the decision of the court of appeals below by abandoning a longstanding position that reflects the state of the law in five circuits, particularly when the reasoning below does not weaken the IRS's conviction that *Shimberg* represents the correct interpretation of the law.[3]

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[2] At least one commentator describes the logic of *Shimberg* as "unassailable" in the context of a pro rata distribution, which is what is involved in this case. See Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)*, 39 Tax L. Rev. 297, 324 (1984).

[3] While it would be inappropriate to engage in an extended discussion of the merits here, we must respond briefly to respondents' repeated assertion (see Br. in Opp. 11 n.12, 13-14 & n.15) that the government's scenario for tax purposes diverges somewhat from what actually happened by allegedly treating the boot as a pre-reorganization dividend. The court of appeals similarly observed (Pet. App. 8a) that *any* analysis for tax purposes must make an assumption that is somewhat unrealistic, because it must view the transaction as if "the boot was received either before or after the reorganization"

In any event, even if the IRS were to reverse its position and adopt the view of the court below, that would not alleviate the administrative difficulties that have impelled us to seek certiorari here. As we have noted, the new position that respondents urge the IRS to take would have the effect of denying to corporate shareholders the intercorporate dividend deduction, and such shareholders would have a strong interest in challenging that position in litigation. Respondents suggest that only a "hardy corporate

(*ibid.*), when in fact it was received in the course of the reorganization. Even if that premise is accepted for purposes of argument, however, the *Shimberg* analysis more closely approximates the actual facts than does the analysis of the court below. Respondents, after all, did in fact receive a distribution of cash in the amount of the earnings and profits that they had accumulated in Basin, which is what the *Shimberg* dividend treatment hypothesizes. By contrast, they never received the NL stock whose redemption was hypothesized by the court below; indeed, as we emphasized in our petition (at 22), the scenario hypothesized by the court below is precisely the option that respondents deliberately chose not to exercise.

Respondents' repeated references to an "integrated approach" (Br. in Opp. 12) appear to suggest that the boot should be viewed as a "payment" (*id.* at 14 n.15) to purchase their Basin stock. Of course, gain from a *sale* of a capital asset is capital gain and, in the absence of Section 356, all of the more than $10 million of gain realized upon the Basin-NL transaction would have been recognized and currently taxed as capital gain. But respondents here sought to have the transaction treated not as a sale, but as a tax-free reorganization under Section 356. See Kyser, *supra,* 39 Tax. L. Rev. at 325-326. The premise of that tax-free treatment is the continuing interest of the participating shareholders in the reorganized entity, and Congress recognized in enacting Section 356 that another consequence of that continuing interest is that boot distributions can have the effect of dividends. Congress could have provided that boot should be taxed on the basis of a hypothetical redemption following a pure stock-for-stock reorganization, but it did not choose to do so. Instead, it provided that a boot distribution that has the effect of a dividend, like the pro rata distribution in this case, should be taxed as a dividend.

taxpayer indeed" (Br. in Opp. 21) would challenge the IRS's unfavorable tax treatment, "even in the Fifth and Twelfth [*sic*] Circuits in which *Shimberg* is nominally authority" (*id.* at 21-22). That suggestion is unduly optimistic, to say the least. It would be surprising if no corporate shareholder, armed with the IRS's prior position and the long line of court of appeals authority we have noted, were willing to litigate an adverse determination by the IRS grounded in the decision below, especially in the five circuits in which the controlling authority would be in the taxpayer's favor.[4] What appears to be respondents' fallback suggestion (see Br. in Opp. 21 n.27)—that the IRS not contest such litigation and thereby permit both corporate and individual shareholders to have the (inconsistent) tax treatment that they desire—cannot be reconciled with the Commissioner's duty to protect the public fisc. In

[4] A recent decision of the Ninth Circuit, *Tribune Publishing Co.* v. *United States*, No. 86-3734 (Jan. 6, 1988), provides one example of a suit brought by a corporate shareholder to obtain dividend treatment for boot received in a reorganization. There, the shareholders of the acquired corporation originally received only shares of stock in the acquiring corporation. Later, shareholders successfully sued the surviving corporation for securities fraud in connection with the reorganization and recovered cash and newsprint discounts. They contended that this recovery was a "boot dividend" under Section 356(a)(2); the IRS took the position that the cash and discounts were not received "in pursuance of the plan of reorganization" (I.R.C. §§ 354, 356). When the court of appeals rejected that contention, it necessarily followed that the payment of cash had the effect of a dividend, and the corporate shareholder was entitled to the favorable dividend treatment it sought. Of course, there are no such recent cases brought by corporate shareholders that are directly on point here; because the IRS has consistently maintained the "*Shimberg* position," as long as it has agreed that the transaction qualifies as part of a reorganization, corporate shareholders have received the tax treatment they desire on the issue presented here without any need to resort to litigation.

short, even if it would be appropriate for the IRS to reverse its longstanding position on this issue and reject the majority view of the courts of appeals, that course of action would still leave it facing repeated litigation with no end in sight until the conflict in the circuits is resolved.

2. Respondents also contend (Br. in Opp. 15-16) that the Court should deny certiorari because the Treasury Department did not oppose a recent legislative proposal that, if enacted, would have embodied in the statute, inter alia, the result reached by the court below. That proposal was not enacted, however, and respondents attribute unwarranted significance to Treasury's failure to oppose it. The legislative proposal was a major revision of numerous provisions of Subchapter C of the Internal Revenue Code, which relates to corporate distributions and reorganizations. The Treasury Department's comments on the proposed draft included a discussion of the proposal to adopt the hypothetical "after-the-fact" redemption approach that forms the basis for the decision below. The Department's comments stated that "[r]esolution of this issue is a very close call," followed by a discussion of the relative merits of each position, which seems to tilt toward the *Shimberg* approach. See *Reform of Corporate Taxation: Hearing Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. 24-25 (1983) [hereinafter *Senate Hearing*]. The Treasury Department's comments then concluded (*id.* at 25): "On balance, we do not object to the Staff's recommended approach in the context of the overall project."[5]

[5] The "overall project" contained many provisions that would have varying effects on the government's tax collections. Thus, while the proposal relevant to this case could have been expected, at least in the case of individual shareholders, to have the effect of reducing the number of "boot dividends" that would be recognized, other aspects of the Subchapter C revision would have had the effect of increasing the amount of dividends recognized. For example, the proposed revision would have relaxed two existing limitations on the amount of a boot dividend—the amount of gain realized and earnings and profits. See *Senate Hearing* 24-25; Staff of the Senate Comm. on Finance, 98th Cong., 1st Sess., *S. Prt. 98-95, The Reform and Simplification of the Income Taxation of Corporations* 63 (Comm. Print 1983); see generally Kyser, *supra*, 39 Tax L. Rev. at 322-323.

Accordingly, the Treasury Department's comments on that legislative proposal (which was not sponsored by the Department) do not remotely suggest that Treasury has ever viewed the *Shimberg* approach as "incorrect" (cf. Br. in Opp. 16). To the contrary, the government has consistently maintained the interpretation of existing law that is reflected in our petition for certiorari.[6] The fact that

[6] Respondents assert (Br. in Opp. 22-24) that the government has not taken a consistent position on the question presented here, and that certiorari should not be granted until the issue "is resolved within petitioner's own ranks" (*id.* at 22). There is no substance to this accusation. The government has consistently maintained that a pro rata distribution to the shareholders of the acquired corporation "has the effect of the distribution of a dividend" under Section 356(a)(2). As we noted in our petition (at 19 n.12), both the IRS in its rulings and the *Shimberg* court recognized that Section 302 principles may play a role in resolving whether dividend treatment is appropriate in some cases, and those statements are fully consistent with our position here. As we also explained in the petition (at 19 & n.12), however, invocation of Section 302 is significant only in the case of a non-pro-rata distribution. In the case of a pro rata distribution like the one here, the distribution is clearly a dividend whether or not one refers to Section 302; focusing on the abstract question whether Section 302 principles apply is only a confusing distraction. See Kyser, *supra*, 39 Tax L. Rev. at 309. Indeed, the extent to which the abstract question of the application of Section 302 principles is a "red herring" in the pro rata distribution context involved here is demonstrated by respondents' own brief. The cases that respondents rely upon to demonstrate that Section 302 principles apply here are precisely the same cases upon which the government has relied (and which respondents have ignored) in showing the consistent line of authority recognizing that pro rata boot distributions should be treated as a dividend (compare Br. in Opp. 8 with Pet. 14-15).

Treasury did not object, "in the context of the overall project," to a legislative proposal that would codify the result below is quite irrelevant to whether certiorari should be granted here. As discussed at the outset, the reasons why the government has sought certiorari in this case pertain to the existence of a conflict in the circuits that creates serious uncertainty in the tax treatment of corporate reorganizations and that places the IRS in an administrative quandary. We would "accept[]" (Br. in Opp. 16)—indeed, welcome—a legislative resolution of that conflict, but there appears to be no reasonable likelihood of such legislative action in the foreseeable future.

As the Tax Court noted (Pet. App. 30a n.9), there have been numerous legislative proposals, dating back to 1954, to amend the Internal Revenue Code to address more explicitly the question of "boot dividends." Some of these proposals would have adopted the approach reflected in the decision below; others would have adopted the *Shimberg* approach. What the proposals have in common is that none of them were enacted into law, and there is no reason to believe that we are any closer to a legislative resolution of this dilemma than we were in 1954 when the first proposal was introduced. Thus, it appears to be left to the courts to decide under existing law cases raising the

issue presented here. Because of the substantial administrative problems, as well as further litigation, that will be engendered by the conflict in the circuits created by the decision below, we believe that resolution of the conflict by this Court is necessary.

For the foregoing reasons and those stated in our petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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